Section 482 and the Aftermath of *Foglesong*: The Beginning or the End for the Personal Service Corporation

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I. INTRODUCTION

Although Congress[1] and the individual state legislatures[2] apparently have long recognized the personal service corporation, the Internal Revenue Service continues to deny its corporate

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[1]For a brief history of the personal service corporation and congressional tax treatment, see Battle, *The Use of Corporations by Persons Who Perform Services to Gain Tax Advantages*, 57 TAXES 797, 801-02 (1979).

[2]*See* ALA. CODE §§ 10-4-220 to -239 (1980); ALASKA STAT. §§ 10.45.010-.140, .220 (1968 & Supp. 1981); ARIZ. REV. STAT. ANN. §§ 10-901 to -909 (1977); ARK. STAT. ANN. §§ 64-1701 to -1717 (medical corporations), 64-1801 to -1817 (dental corporations), 64-2001 to -2018 (professional corporations) (1980); CAL. CORP. CODE §§ 13400-10 (West 1977 & Supp. 1981); COLO. REV. STAT. §§ 12-2-101, -117 to -118, -131 (accounting), 12-33-124 (chiropractic), 12-36-134 (medical), 12-40-125 (optometric), 12-41-130 (physical therapy), 12-43-118 (psychological) (1978 & Supp. 1980); CONN. GEN. STAT. §§ 33-182a to -182j (Supp. 1981); DEL. CODE ANN. tit. 8, §§ 601-19 (1974 & Supp. 1980); D.C. CODE ANN. §§ 29-601 to -621 (1981); FLA. STAT. ANN. §§ 621.01-.15 (West 1977 & Supp. 1982); GA. CODE §§ 84-5401 to -5407 (1979 & Supp. 1981); HAWAII REV. STAT. §§ 416-141 to -154 (1976 & Supp. 1981); IDAHO CODE §§ 30-1301 to -1315 (1980 & Supp. 1981); ILL. REV. STAT. ch. 32, §§ 415-1 to -18 (Professional Service Corporation Act, P.A. 76-1283) (1979 & Supp. 1980); IND. CODE §§ 23-1-13-1 to -11 (general professional), 23-1-13.5-1 to -6 (accounting), 23-1-14-1 to -21 (medical), 23-1-15-1 to -21 (dental) (1976 & Supp. 1981); IOWA CODE §§ 496C.1-.22 (Supp. 1981); KAN. STAT. ANN. §§ 17-2706 to -2719 (1974 & Supp. 1980); KY. REV. STAT. ANN. §§ 274.005-.990 (1981); LA. REV. STAT. ANN. §§ 12:801-:815 (legal), 12:901-:915 (medical) (West 1969 & Supp. 1981), §§ 12:981-:995 (dental), 12:1011-:1012 (accounting), 12:1051-:1065 (chiropractic), 12:1071-:1085 (nursing), 12:1086-:1101 (architectural), 12:1110-:1124 (optometric), 12:1130-:1144 (psychological) (West Supp. 1981); ME. REV. STAT. ANN. tit. 13, §§ 701-716 (1981); MD. CORP. & ASS'NS CODE ANN. §§ 5-101 to -122 (1975 & Supp. 1981); MASS. GEN. LAWS ANN. ch. 156A, §§ 1-17 (West 1970 & Supp. 1981); MICH. COMP. LAWS §§ 450.221-.235 (1970); MINN. STAT. ANN. §§ 319A.01-.22 (West Supp. 1981); MISS. CODE ANN. §§ 79-9-1 to -27 (1972); MO. ANN. STAT. §§ 356.010-.200 (Vernon 1966 & Supp. 1982); MONT. REV. CODES ANN. §§ 15-2101 to -2116 (1967 & Supp. 1977); NEB. REV. STAT. §§ 21-2201 to -2222 (1977 & Supp. 1980); NEV. REV. STAT. §§ 89.010-.110 (1979); N.H. REV. STAT. ANN. §§ 294-A:1-:8 (Supp. 1973); N.J. STAT. ANN. §§ 14A:17-1 to -18 (West Supp. 1981); N.M. STAT. ANN. §§ 53-6-1 to -14 (1978); N.Y. BUS. CORP. LAW §§ 1501-16 (McKinney Supp. 1981); N.C. GEN. STAT. §§ 55B-1 to -15 (1975 & Supp. 1979); N.D. CENT. CODE §§ 10-31-01 to -14 (1976); OHIO REV. CODE ANN. §§ 1785.01-.08 (Page 1978 & Supp. 1981); OKLA. STAT. ANN. tit. 18, §§ 801-819 (West Supp. 1981); OR. REV. STAT. §§ 58.005-.365 (1973); PA. STAT. ANN. tit. 15, §§ 12601-12619 (Purdon 1967); R.I. GEN. LAWS §§ 7-5.1-1 to -12 (1969 & Supp. 1980); S.C. CODE §§ 33-51-10 to -170 (1976 & Supp. 1981); S.D. COMP. LAWS ANN. §§ 47-11-1 to -21 (medical), 47-12-1 to -21 (dental), 47-13-1 to -21 (veterinary) (1967 & Supp. 1981), 47-11A-1 to -20 (chiropractic), 47-11B-1 to -23 (optometric), 47-11C-1 to -23 (podiatric), 47-13A-1 to -10

existence.[3] The war between the personal service corporation and the Service has been a longstanding one[4] waged on numerous fronts,[5] with battles and skirmishes won by both sides.[6] The final battle, however, has not yet been fought; the war rages on.[7]

The personal service corporation has been defined as "a corporation whose income is to be ascribed to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital . . . is not a material income-producing factor . . . ."[8] Falling within the ambit of this definition are the professional corporation, particularly the one "professional" situation,[9] self-employed persons who incorporate,[10] and members of a partnership who individually incorporate.[11]

(legal), 47-13B-1 to -18 (accounting) (Supp. 1981); TENN. CODE ANN. §§ 48-2001 to -2007 (1979); TEX. REV. CIV. STAT. ANN. art. 1528e, §§ 1-20 (Vernon 1980); UTAH CODE ANN. §§ 16-11-1 to -15 (1973 & Supp. 1981); VT. STAT. ANN. tit. 11, §§ 801-813 (1973 & Supp. 1981); VA. CODE §§ 13.1-542 to -556 (1978 & Supp. 1981); WASH. REV. CODE ANN. §§ 18.100.010-.140 (1978); W. VA. CODE §§ 30-2-5-5a (legal), 30-3-15 (medical), 30-4-4b-4c (dental), 30-8-3a-3b (optometric), 30-9-4a (accounting), 30-10-18 (veterinary), 30-14-9a (osteopathic), 30-16-17 (chiropractic) (1980 & Supp. 1981); WIS. STAT. ANN. §§ 180.99(1)-(11) (West Supp. 1981), WYO. STAT. §§ 17-3-101,-102 (1977), 17-3-103, -104 (Supp. 1981).

[3]Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,401, at 4183; Achiro v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38, 351, at 4089; Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,423, at 4245.

[4]*See, e.g.*, Kurzner v. United States, 413 F.2d 97 (5th Cir. 1969); O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969); United States v. Kintner, 216 F.2d 418 (9th Cir. 1954); Laughton v. Commissioner, 40 B.T.A. 101 (1939), *remanded*, 113 F.2d 103 (9th Cir.), *dismissed*, 43 B.T.A. 1207 (1940); Fox v. Commissioner, 37 B.T.A. 271 (1938).

[5]*See* notes 14-16 *infra* and accompanying text.

[6]For example, the effectiveness of the sham corporation argument asserted in Laughton v. Commissioner, 40 B.T.A. 101 (1939), and Fox v. Commissioner, 37 B.T.A. 271 (1938), was severely reduced by the case of Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). *See* notes 49-52 *infra* and accompanying text. On the other hand, Ach v. Commissioner, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966), and Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968), represented a broad reading of the "two or more organizations, trades or businesses" requirement of section 482 and opened that section up to the Service as an alternative to the assignment of income doctrine.

[7]*See* Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,423, at 4245.

[8]Revenue Act of 1918, ch. 18, § 200, 40 Stat. 1057, 1059 (1919).

[9]*See generally* McFadden, *Section 482 and the Professional Corporation: The* Foglesong *Case*, 8 J. CORP. TAX. 35, 35 (1981).

[10]*See, e.g.*, Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4245.

[11]*See, e.g.*, Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4183.

The conflict posed by these corporations to taxing authorities is that while the shareholder-employee performs all the services, the corporation claims to have earned the income; failure to recognize this seeming paradox, however, constitutes a condemnation of the "corporateness" of the entity.[12] Thus, the primary issue is whether income earned from the services rendered should be taxed to the corporation or to the employee-shareholder who personally performed the service.[13]

In an effort to resolve the conceptual difficulties posed by these corporations and to ensure that the "true earner" is taxed, the Service has relied on a number of theories to ignore or bypass the corporation: sham corporation,[14] assignment of income,[15] and section 482.[16] Arguing under the sham corporation theory, the Service asserts that the personal service corporation is merely a "dummy" or "alter ego" for the *true* taxpayer, the employee.[17] Reliance on the assignment of income doctrine, which requires that income be taxed to the true earner,[18] purportedly causes the same desirous result for the Service by shifting the income from the corporation back to the employee who actually *earned* it. Section 482 allows the Commis-

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[12]The court in Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970), aptly noted the problem.

> [Personal service corporation] cases . . . reveal a tension between competing policies of the tax law. On one side is the principle of a graduated income tax, which is undercut when individuals are permitted to split their income with others or to spread it over several years. Opposing this is the policy of recognizing the corporation as a taxable entity distinct from its shareholders in all but extreme cases.

Id. at 652 (citations omitted).

[13]*See* Battle, *supra* note 1, at 801.

[14]*See, e.g.*, Morrison v. Commissioner, 54 T.C. 758 (1970); Noonan v. Commissioner, 52 T.C. 907 (1969); Laughton v. Commissioner, 40 B.T.A. 101 (1939); Fox v. Commissioner, 37 B.T.A. 271 (1938).

[15]*See, e.g.*, Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976); American Sav. Bank v. Commissioner, 56 T.C. 828 (1971); Rubin v. Commissioner, 51 T.C. 251 (1968), *rev'd and remanded*, 429 F.2d 650 (2d Cir. 1970).

[16]*See, e.g., Keller v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4183; Achiro v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4089; Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4245; Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968); Ach v. Commissioner, 42 T.C. 114 (1964).

These are not the sole arguments raised by the Service against the personal service corporation. Other arguments include: substance over form, *see, e.g.*, Rubin v. Commissioner, 51 T.C. 251 (1968), *rev'd and remanded*, 429 F.2d 650 (2d Cir. 1970), and section 269, *see, e.g.*, Achiro v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4089; Battle, *supra* note 1, at 803.

[17]*See* notes 39-43 *infra* and accompanying text.

[18]Lucas v. Earl, 281 U.S. 111 (1930). *See* notes 61-67 *infra* and accompanying text.

sioner to reallocate income between two commonly controlled "organizations, trades, or businesses" to prevent tax avoidance or to clearly reflect income.[19] The personal service corporation and its principal shareholder-employees have been held to meet this two business requirement and are thus subject to the provisions of section 482.[20] Unlike the other two judicially-created concepts, however, section 482 arguably maintains the integrity of the corporate entity.[21]

While the Service appears to prefer the assignment of income doctrine,[22] the Second Circuit[23] and, more recently, the Seventh Circuit Court of Appeals[24] have rejected this means of allocating income and have indicated that the preferred method is that of using section 482.[25] Although commentators have suggested that section 482 might represent the death knell for the personal service corporation,[26] the Tax Court cases which have been decided since *Foglesong v. Commissioner* have indicated that section 482 may be the salvation for these entities struggling for simple recognition by taxing authorities of their validity.[27]

This Article will briefly review the judicially-created methods used by the Service to attack the income distribution of the personal service corporation and will discuss those situations in which each method retains vitality. The development of section 482 as it affects the personal service corporation will be traced. An analysis of the *Foglesong* trilogy will be followed by a discussion of the Tax Court personal service corporation cases that have been decided since that Seventh Circuit decision. Finally, use of section 482 in these recent cases will be discussed in terms of future impact and effect on planning for the personal service corporation.

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[19]I.R.C. § 482.

[20]*See, e.g.*, Ach v. Commissioner, 42 T.C. 114 (1964).

[21]*See* Foglesong v. Commissioner, 621 F.2d 865 (7th Cir. 1980).

[22]I.R.S. Letter Rul. Rep. (CCH) No. 8031028.

[23]Rubin v. Commissioner, 51 T.C. 251 (1968), *rev'd and remanded*, 429 F.2d 650 (2d Cir. 1970), *on remand*, 56 T.C. 1155 (1971), *aff'd*, 460 F.2d 1216 (2d Cir. 1972).

[24]Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4245.

[25]621 F.2d at 872; 429 F.2d at 653-54.

[26]*See* Burdett, Foglesong's *Sec. 482 Approach May Threaten Closely-Held Personal Service Corporations*, 53 J. TAX. 330 (1980); Feuer, *Section 482, Assignment of Income Principles and Personal Service Corporations*, 59 TAXES 564 (1981); McFadden, *supra* note 9.

[27]*See, e.g.*, Foglesong v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,423, at 4245; Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,401, at 4183; Achiro v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38, 351, at 4089.

II. Common Law Attacks on the Personal Service Corporation

The arguments used by the Service reflect the progression of attitude, development, and understanding that the courts have displayed toward the personal service corporation through the years. Nonetheless, with every transition, setback, and defeat, the Service has always prepared a new strategy for attack when an old one loses momentum.

The conflict between one type of personal service corporation, the professional corporation, and the Service illustrates the attitude of ongoing antagonism. This background is included, by way of introduction to the other methods used by taxing authorities, to demonstrate the degree of commitment that the Service has shown to prove the "non-corporateness" of the personal service corporation.

The Service initially argued that corporate standing should be readily conferred on professional or personal service *associations*[28] because the corporate label carried greater tax liability.[29] Changes in the corporate tax laws, however, caused an attitude reversal by the Service toward these entities.[30] Nonetheless, the courts were not as eager as the Service to deny corporate status where it formerly had been recognized.[31] To overcome this problem, the Service promulgated treasury regulations[32] designed to limit the broad definition of corporation which had developed because of former regulations[33] and previous court decisions.[34] Professionals who were adversely affected responded by requesting assistance from the state legislatures; the swift answer was to permit professional associations to incorporate.[35] The Service countered with amended regula-

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[28]At that time, incorporating often was prevented by local law or professional ethics. However, associations offered many of the same benefits as corporate status. *See generally* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 2.06 (3d ed. 1971).

[29]For an interesting synopsis of the government's approach to conferring the corporate label for federal tax purposes and its subsequent turnaround, see Kurzner v. United States, 413 F.2d 97, 100-01 (5th Cir. 1969). *See generally* Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 Minn. L. Rev. 603 (1965).

[30]*See* United States v. Kintner, 216 F.2d 418 (9th Cir. 1954).

[31]*See id.*; Foreman v. United States, 232 F. Supp. 134 (S.D. Fla. 1964); Galt v. United States, 175 F. Supp. 360 (N.D. Tex. 1959).

[32]Treas. Reg. §§ 301.7701-1 to -11, 26 C.F.R. §§ 301.7701-1 to -11 (1981). *See* Kurzner v. United States, 413 F.2d at 101, *citing* United States v. Kintner, 216 F.2d 418, 423 (9th Cir. 1954).

[33]*See, e.g.*, Treas. Reg. 111, §§ 29.3797-2,-4; 26 C.F.R. §§ 29.3797-2,-4 (1981).

[34]*See* note 31 *supra.*

[35]*See* Kurzner v. United States, 413 F.2d at 106. For a listing of the state statutes, see note 2 *supra.*

tions which stated that professional corporations were *not* corporations for federal tax purposes.[36] The court reaction to the amended regulations was uniformly unfavorable and the regulations were invalidated.[37]

Having been ineffective at denying corporate status on the broad scale, the Service began attacking the professional corporation in the same manner that it had attacked other types of personal service corporations: by using the sham corporation and assignment of income arguments.

A. Sham Corporation

The sham corporation argument has undergone a metamorphosis with respect to the personal service corporation, but its function remains the same: to disregard the corporate entity and tax the income to the shareholder-employee(s).[38]

Two early cases, *Fox v. Commissioner*[39] and *Laughton v. Commissioner*,[40] represent the genesis of the sham corporation argument. The issue raised was whether the personal service corporation should be disregarded as "a mere dummy"[41] or as an "alter ego"[42] of the shareholder-employee for federal tax purposes.[43] In *Fox*, Fon-

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[36]Treas. Reg. § 301.7701-1(c) (1965). The amended regulation added the following language:

> Nevertheless, the labels applied by local law to organizations, which may now or hereafter be authorized by local law, are in and of themselves of no importance in the classifications of such organizations for the purposes of taxation under the Internal Revenue Code. Thus, a professional service organization, formed under the law of a State authorizing the formation by one or more persons of a so-called professional service corporation, would not be classified for purposes of taxation as a "corporation" merely because the organization was so labeled under local law. The classification in which a professional service organization belongs is determined under the tests and standards set forth in §§ 301.7701-2, 301.7701-3 and 301.7701-4.

Id.

[37]*See, e.g.*, Kurzner v. United States, 413 F.2d 97 (5th Cir. 1969), *aff'g* 286 F. Supp. 839 (S.D. Fla. 1968); O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969), *aff'g* 281 F. Supp. 359 (N.D. Ohio 1968); United States v. Empey, 406 F.2d 157 (10th Cir. 1969), *aff'g* 272 F. Supp. 851 (D. Colo. 1967); Smith v. United States, 301 F. Supp. 1016 (S.D. Fla. 1969); Cochran v. United States, 299 F. Supp. 1113 (D. Ariz. 1969); Wallace v. United States, 294 F. Supp. 1225 (E.D. Ark. 1968); Holder v. United States, 289 F. Supp. 160 (N.D. Ga. 1968).

[38]*Compare* Laughton v. Commissioner, 40 B.T.A. 101 (1939) (alter ego or agent) *and* Fox v. Commissioner, 37 B.T.A. 271 (1938) (mere dummy) *with* Noonan v. Commissioner, 52 T.C. 907 (1969) (substantial business purpose).

[39]37 B.T.A. 271 (1938).

[40]40 B.T.A. 101 (1939).

[41]37 B.T.A. at 276.

[42]40 B.T.A. at 105.

[43]*Id.*; 37 B.T.A. at 276.

taine Fox, a noted cartoonist, formed a corporation of which he became president and majority shareholder, signed an employment contract with the corporation for his exclusive services at a designated salary, and transferred certain contracts for his cartoons and the copyrights of his cartoons to the corporation. The corporation,[44] in turn, contracted with others to distribute the cartoons in exchange for a percentage fee. In *Laughton*, a famous English actor, Charles Laughton, contracted to work five years exclusively for a corporation that he beneficially owned. The actor was paid a fixed salary. The corporation contracted with moving picture producers and studios for Laughton's talents and received the fruits of his labors.

In both cases, the Board of Tax Appeals relied on *New Colonial Ice Co., Inc. v. Helvering*.[45]

> As a general rule a corporation and its stockholders are deemed separate entities and this is true in respect of tax problems. Of course, the rule is subject to the qualification that the separate identity may be disregarded in exceptional situations where it otherwise would present an obstacle to the due protection or enforcement of public or private rights.[46]

Finding no "exceptional situation" and noting that the corporations' identities had been respected, the Board found that the facts did not warrant the disregard of the corporate entity; thus, valid corporations existed for federal tax purposes.[47]

The sham corporation argument as it existed in *Fox* and *Laughton* lost prominence in all but the most extreme situations[48] after the Supreme Court decided *Moline Properties, Inc. v. Commissioner*.[49] In that case, an individual transferred property to his corporation under a special mortgage arrangement. The property was later sold at a profit and the shareholder sought to have the gain taxed to him individually because of tax advantages. The Court found that the corporation was valid and taxed the gain to the corporation.[50]

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[44]37 B.T.A. at 275. The board of directors was composed of Fontaine Fox (98 shares), president, C.E. Kelley (1 share), Fontaine's attorney and secretary of the corporation, and Barton Fox (1 share), his brother and treasurer. The stipulation of facts recognized that Fox "conducted the affairs of [the corporation]." *Id.*

[45]292 U.S. 435 (1934).

[46]*Id.* at 442 (citations omitted).

[47]40 B.T.A. at 107; 37 B.T.A. at 277.

[48]*See* notes 53-56 *infra* and accompanying text.

[49]319 U.S. 436 (1943).

[50]*Id.* at 440.

In reaching its decision, the Court established the standard by which to judge the existence of a corporation.

> Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the *equivalent of business activity* or is *followed by the carrying on of business by the corporation, the corporation* remains a separate *taxable* entity.[51]

Although the Court did add the proviso that "the corporate form may be disregarded where it is a sham or unreal,"[52] the sham corporation concept as it existed in *Fox* and *Laughton* lost vitality in the personal service corporation context.

Although the court in *Roubik v. Commissioner*[53] did not expressly find that the corporation involved was a sham, the case represents the type of extreme factual situation where the sham corporation attack could fairly be argued.[54] In *Roubik*, four radiologists had formed a professional corporation. The individuals, nonetheless, continued to contract personally with the institutions that were served; the corporation had no control over institutional assignments. No equipment was owned by the corporation and few operating expenses were incurred.[55] The concurring opinion aptly stated that the professionals had simply failed to "put flesh on the bones of the corporate skeleton . . . ."[56] Thus, in a factual context where the corporate "formalities" are respected, the sham corporation argument poses no serious threat to the personal service corporation.

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[51]*Id.* at 438-39 (footnotes omitted) (emphasis added).

[52]*Id.* at 439.

[53]53 T.C. 365 (1969).

[54]Judge Cudahy in Foglesong v. Commissioner, 621 F.2d 865 (7th Cir. 1980), commenting on the *Roubik* case, said: "In short, the corporate form was repeatedly flouted. Indeed, it would be fair to say that the corporation was not an operating enterprise and, in fact, to conclude (although the Tax Court did not do so in *haec verba*) that the corporation was a sham." *Id.* at 871.

[55]53 T.C. at 379. The tax court stated:

> Pfeffer Associates appears to have existed during 1965 as a mere set of bookkeeping entries and bank accounts. . . . It did not own any equipment, incur any debts for rent, office or medical supplies or services or for salaries, except for the salaries of the petitioners. The only "shared" expense . . . was $45 a month for the time Ramin's Hampton office secretary devoted to maintaining records of income and expenses received and paid by Pfeffer Associates. The maintenance of these records for tax purposes appears to be the only real business activity engaged in by the corporation.

Id.

[56]*Id.* at 382 (Tannenwald, J., concurring).

The sham corporation attack, however, did not die after *Moline Properties*; the weapon merely changed form.[57] The Service continues to present this attack generally in conjunction with its assignment of income argument.[58] The focus of its concern, however, is typically whether the personal service corporation has met the *Moline Properties* business activities test.[59]

It should be noted, as the Tax Court recently did,[60] that there is a *close* relationship between the sham corporation and the assignment of income attacks, even when the prior is not presented: "Although [the Service] maintains that it is not Keller, Inc.'s classification as a corporation that is being disputed, but rather the determination of the true earner of the instant income which is in issue, this distinction is largely semantic rather than substantive."[61]

B. Assignment of Income

In the personal service corporation context, the assignment of income doctrine has been used to *bypass* the corporation and to tax the income to the "true earner," the employee.[62] The desired result of this attack is the same as with the sham corporation argument, the corporation is ignored.[63]

Denoted as "the first principle of income taxation,"[64] the assignment of income doctrine requires that income be taxed to the party who earned it.[65] The doctrine was first established in the landmark case of *Lucas v. Earl*[66] where the taxpayer, an attorney, contracted with his wife for joint ownership of everything they had or might acquire, including earnings. Thereafter, the husband only reported half of his income. Holding that the taxpayer was taxable on the entire income, Justice Holmes created the now-famous fruit and tree metaphor:

> [T]his case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the tax-

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[57]*See* note 38 *supra* and accompanying text.

[58]*See, e.g.*, Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976).

[59]*See, e.g.*, Morrison v. Commissioner, 54 T.C. 758 (1970); Noonan v. Commissioner, 52 T.C. 907 (1969).

[60]Keller v. Commissioner, [1981 Transfer Binder] Tax Ct. Rep. (CCH) No. 38,401, at 4183.

[61]*Id.* at 4194.

[62]*See, e.g.*, Jones v. Commissioner, 64 T.C. 1066 (1975); American Sav. Bank v. Commissioner, 56 T.C. 828 (1971); Rubin v. Commissioner, 51 T.C. 251 (1968), *rev'd and remanded*, 429 F.2d 650 (2d Cir. 1970).

[63]*See* notes 60-61 *supra* and accompanying text.

[64]Commissioner v. Culbertson, 337 U.S. 733, 739 (1949).

[65]*Id.* at 739-40.

[66]281 U.S. 111 (1930).

> ing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could *not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it.* That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.[67]

Thereafter, any arrangement which *even suggested* an artificial shifting of income was closely and often laboriously scrutinized. The personal service corporation by its very nature reeked with this suggestion.[68]

With the exception of early cases,[69] the Tax Court has been very receptive to the assignment of income attack in the personal service corporation situation.[70] Some of the decided cases are unquestionably justifiable because the "employee" *was* the true earner.[71] Other cases, however, are not easily reconciled without admitting that the corporate entity was completely ignored.[72]

The "easy" cases epitomize the situation where either the requisite formalities were not followed or a law precluded certain corporate action, and therefore, the corporation could not have *earned* the income. In *Jones v. Commissioner*,[73] a federal court reporter

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[67]*Id.* at 114-15 (emphasis added).

[68]The tax court in American Sav. Bank v. Commissioner, 56 T.C. 828 (1971), admitted its dilemma.

> [T]he conceptually difficult arrangement where an individual performs services thereby earning the income that is received and the next day performs the same services and the compensation, when paid to a corporation wholly owned by that individual, is said to have been earned by the corporation. The patent artificiality of such a situation leads this Court to carefully scrutinize any such arrangement to assure that an individual is not merely siphoning off income to another entity at the expense of the public fisc.

Id. at 839.

[69]Laughton v. Commissioner, 40 B.T.A. 101 (1939); Fox v. Commissioner, 37 B.T.A. 271 (1938).

[70]*See, e.g.*, McIver v. Commissioner, 36 T.C.M. (CCH) 719 (1977); Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976); Jones v. Commissioner, 64 T.C. 1066 (1975); Shaw v. Commissioner, 59 T.C. 375 (1972); American Sav. Bank v. Commissioner, 56 T.C. 828 (1971); Rubin v. Commissioner, 51 T.C. 251 (1968). *But see* Gettler v. Commissioner, 34 T.C.M. (CCH) 442 (1975); Estate of Cole v. Commissioner, 32 T.C.M. (CCH) 313 (1973).

[71]*See* notes 73-79 *infra* and accompanying text.

[72]*See* notes 87-93 *infra* and accompanying text.

[73]64 T.C. 1066 (1975). *Jones* was also decided on the basis of section 482. *Id.* at 1077-79.

formed a corporation to conduct the business of court reporting. The court noted that the taxpayer had not assigned any of his rights or obligations as a court reporter to the corporation, and had not executed an employment contract. The court, however, relied primarily on a statute that required the court reporter *personally* to prepare, certify, and sell the transcripts.[74] Because the corporation could not itself be a court reporter, the court held that Mr. Jones was the true earner.[75] Likewise, in *McIver v. Commissioner*,[76] the taxpayer sought to have a brokerage commission taxed as income to his corporation which was not licensed as a real estate broker; the corporate receipt of the commission would have been a violation of the state law. Although the illegality of the transaction would not affect the taxation if it was indeed earned by the corporation, the court held that the income in this instance was earned by Mr. McIver functioning as a real estate broker and not as an agent of the corporation.[77] Finally, *Roubik v. Commissioner*[78] represents a case in which the corporation was permitted to do nothing and therefore could not have earned the income.[79]

Most of the cases, however, do not fall into the "easy" category and their common conclusion that the corporation did not earn the income is not readily justified. Again *Fox*[80] and *Laughton*[81] provide the historical backdrop, but also intensify the confusion.

In *Fox*, Fontaine Fox assigned all copyright interests in his cartoons to his corporation and signed an employment contract for his services to be rendered exclusively for his corporation. The corporation then contracted with third parties for Fox's services. The Board of Tax Appeals found that, because Fox had not personally contracted with third parties for his services and implicitly because he

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[74] *Id.* at 1076-77.

[75] *Id.*

[76] 36 T.C.M. (CCH) 719 (1977).

[77] *Id.* at 722-23.

[78] 53 T.C. 365 (1969). *Roubik* was not based on the sham corporation, although it represents the extreme situation where it would be appropriate, *see* notes 53-56 *supra* and accompaning text; the case was decided using the assignment of income doctrine. *Id.*

[79] 53 T.C. at 380-81. The *Roubik* court noted:

> The corporation for instance did not hire the personnel . . . . *It* did not determine their salaries, or supervise them in their employments. Ramin did. . . . As a practical matter, Ramin's conduct of this office was a matter of indifference to the corporation, which served simply as a conduit for income and expense items. . . . [O]n the facts of the present case . . . the corporation, . . . had nothing to do with the earning of the amounts of income involved here.

Id. (emphasis in original).

[80] 37 B.T.A. 271 (1938).

[81] 40 B.T.A. 101 (1939).

was contractually bound to the corporation, no assignment of income resulted.[82]

In *Laughton*, Charles Laughton contracted to provide his exclusive services to the corporation in exchange for a fixed salary, subject to certain contracts that Laughton had previously executed with other production companies. Laughton assigned the profits of these contracts to the corporation in consideration for his employment contract. The corporation then contracted with production studios for the "loan" of its employee, although Laughton personally acknowledged in writing that "he obligated himself, individually, to render the services agreed upon by the studios and [the corporation]."[83] Finding this situation virtually indistinguishable from that in *Fox*[84] and noting that the only contract Laughton had with the corporation and the studios was "to consent to the performance of the services,"[85] the Board again held that there had been no assignment of income.[86] Both cases taxed the income to the corporation even though the predominant earnings were the result of the services of the shareholder-employee and that employee received a salary substantially less than he would have without the corporate structure.[87]

While providing a weapon for the taxpayer, distinguishing these cases became an art for the Service. *Rubin v. Commissioner*[88] provided the first major opportunity following *Fox* and *Laughton* for

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[82]37 B.T.A. at 277-78. Following the creation of the corporation, Fox personally executed three contracts for the use of his cartoon characters in motion pictures, in toy manufacturing, and in advertising. All funds received pursuant to these contracts were used and reported by Fox. Subsequently, his attorney questioned the validity of the contracts because the corporation, not Fox, held the copyright at the time of contracting. Fox assigned the contracts to the corporation which reported the income thereafter. The court recognized that the assignment of the contracts constituted a transfer of income producing property and as such, income earned thereafter was properly taxed to the assignee, the corporation. *Id.* at 278.

[83]40 B.T.A. at 104.

[84]*Id.* at 106-07.

[85]*Id.* at 106.

[86]*Id.* at 106-07.

[87]*Id.* at 105-07; 37 B.T.A. at 275-76. *Laughton* was appealed to federal court for consideration in light of the Supreme Court decision of Higgins v. Smith, 308 U.S. 473 (1940). Commissioner v. Laughton, 113 F.2d 103 (9th Cir. 1940). *Higgins* had recognized that an individual taxpayer could not sell stock to his "corporate self" at a loss for tax purposes. 308 U.S. at 475-76. Based on *Higgins*, the court remanded the case for consideration of "whether Laughton's hiring of himself to [the corporation] for a salary substantially less than the compensation for which the corporation supplied his services as its employee to various motion picture producers, constituted, in effect, a single transaction by Laughton in which he received indirectly the larger sum paid by the producers." 113 F.2d at 104. On remand, the case was settled by stipulation. *See* Battle, *supra* note 1, at 802 n.52.

[88]51 T.C. 251 (1968).

head-to-head confrontation on the assignment of income question in the personal service corporation context.

In 1956, Richard Rubin, an officer of Rubin Bros., formed Park International, Inc., to help Dorman Mills, a good customer of the family corporation, to overcome some significant financial difficulties. Richard held 70% of the Park stock and his two brothers held the remaining 30%. Park contracted with Dorman Mills to provide a loan and management services in exchange for 25% of the annual net profits over $25,000. Dorman Mills understood that Richard would personally perform the management services even though the contract did not expressly provide for such. During the same time, Richard individually contracted with the controlling shareholder of Dorman Mills for a four-year purchase option on the control block of stock and for the right to vote the stock during the option period. Within a few years, Dorman Mills made a slow recovery and began to show a profit. By 1959, it had repaid Park for the loan and was making payments under the contract terms. Park used the money to pay salaries and to purchase art for appreciation and for resale. The two brothers ran the art business while Richard, now Dorman Mills' controlling shareholder, continued to provide management under the contract until another corportion took over Dorman Mills in 1963.

The Tax Court found that Richard *worked* for *Dorman Mills* and that he gave portions of his *compensation* to Park as capital for the art business, using the substance-over-form doctrine.[89] The court recognized, however, that the same result could be reached using an assignment of income analysis.[90]

Relying heavily on the joint work of two noted commentators,[91]

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[89]*Id.* at 265. The court noted the substance-form differentiation: "In form petitioner worked for Park, Park managed Dorman Mills, and the excess of the net Dorman Mills' fees over petitioner's salary remained in Park for use in its art business. . . . [I]n substance petitioner worked *directly* for Dorman Mills. . . ." *Id.* (emphasis added).

[90]*Id.*

[91]Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the* P.G. Lake *Case*, 17 TAX L. REV. 295 (1962). Of "loaned employee" situations, the authors stated:

> The distinction in these cases is grounded on the question of who has the ultimate direction and control over the earning of this compensation. If such control lies with the taxpayer who actually performs the services, then he remains taxable on the earnings from his personal services, whether or not he chooses to divert the receipt of that compensation to a third party. However, if the direction and control of the performer's activities resides in a superior authority, and the consideration paid for the performance of those services is made to the person having such ultimate direction and control, then the mere fact that the taxpayer has performed the services does not render him taxable on the amount paid for those services.

Id. at 393 (footnotes omitted), *quoted in* Rubin v. Commissioner, 51 T.C. 251, 265-66 (1968).

Interestingly, the authors were discussing loaned employees generally and the

the court noted that the crucial question in this context was "who controls the earning of the income."[92] From this standpoint, the court easily concluded that the "employee" and not the corporation directed and controlled the earning, and therefore, earned the income.[93] Although *Fox* and *Laughton* were considered, the present fact situation was distinguished on two grounds: 1) the absence of an employment contract between Richard and Park; and 2) Richard's control of both parties to the transaction, Park and Dorman Mills.[94] Therefore, Richard was held personally taxable on the money that Dorman Mills had paid to Park under the contract terms.

Although *Rubin* was reversed and remanded on appeal,[95] the control concern introduced by the Tax Court gained prominence.[96] Given the nature of the personal service corporation, the control issue presented a powerful weapon to the Service. Suggestions have been made that employment contracts with covenants not to compete between the corporation and the shareholder-employee should be sufficient to overcome this argument;[97] the question, however, is unsettled.

The circuit court decisions in *Rubin* and most recently, in *Foglesong v. Commissioner*,[98] nonetheless, have introduced the questions of whether the assignment of income doctrine is appropriate for the personal service corporations, and if so, when it should be utilized.[99]

The Second Circuit in *Rubin* found that the common law doctrines used by the tax court were "blunt tools."

> References to "substance over form" and the "true earner" of income merely restate the issue in cases like this: Who *is* the "true earner"? What *is* substance and what *is* form? Moreover, they do so in a way which makes it appear

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cited cases involved non-personal service corporations. *See, e.g.*, Wilgus v. Commissioner, 20 T.C.M. (CCH) 752 (1961). *Fox* and *Laughton* were not cited or discussed. It is difficult to imagine how the broad statements of the authors could be reconciled with the *Fox* result.

[92]51 T.C. at 265.

[93]*Id.* at 266.

[94]*Id.* at 266-67.

[95]429 F.2d 650 (2d Cir. 1970).

[96]*See, e.g.*, Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976); Ronan State Bank v. Commissioner, 62 T.C. 27 (1974); Shaw v. Commissioner, 59 T.C. 375 (1972); American Sav. Bank v. Commissioner, 56 T.C. 828 (1971).

[97]*See* Battle, *supra* note 1, at 805; Feuer, *supra* note 26, at 567-68.

[98]621 F.2d 865 (7th Cir. 1980).

[99]*See id.* at 872; 429 F.2d at 653. *See also* Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,401, at 4202-04 (Wilbur, J., dissenting).

> that these questions can be answered simply by viewing the facts with appropriate suspicion.[100]

After thus noting that the assignment of income doctrine was not well-designed for the personal service corporation, the court indicated that section 482 was a more precise tool and, indeed, was the appropriate means of solving the problems presented by these corporations.[101] The appellate court also discussed the distinguishing features between the *Rubin* facts and those in *Fox*.[102] The court found them to be irrelevant with respect to the common law doctrines relied on by the Tax Court.[103]

In *Foglesong v. Commissioner*, the Seventh Circuit, bolstered by the *Rubin* decision, also found the common law techniques to be an awkward means to accomplish their purposes.[104] In so doing, the court explicitly recognized that the assignment of income doctrine was used to disregard the corporation through the balancing of tax avoidance motives and legitimate business purposes.[105]

> Such an approach places too low a value on the policy of the law to recognize corporations as economic actors except in exceptional circumstances. This is true whether the analysis used to *dismantle the corporation* pursues the rubric of assignment of income or substance over form. Here there are other more precise devices for coping with the unacceptable tax avoidance . . . . *But there is no need to crack walnuts with a sledgehammer.*[106]

The court determined that section 482 would be a better method to accomplish the same purpose without losing the integrity of the entity.[107]

The *future* of the common law doctrines with respect to personal service corporations generally is uncertain as is the *present* in the Tax Courts in the Second and Seventh Circuits.[108] Even where the common law doctrines maintain some vitality, the *Rubin* and

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[100]429 F.2d at 653 (emphasis added).

[101]*Id.* at 653-54.

[102]*See* note 94 *supra* and accompanying text.

[103]429 F.2d at 654.

[104]621 F.2d at 869, 872.

[105]*Id.*

[106]*Id.* at 872 (emphasis added).

[107]*Id.* at 872-73. The court recognized the validity of the corporation and found that the "corporate tree seems sturdy enough to become fruit-bearing, subject, of course, to whatever pruning (radical or otherwise) by the tax collector appears appropriate." *Id.* at 873.

[108]*See, e.g.*, Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4183.

Foglesong reasoning may be used as an effective weapon against them. With increasing regularity, the Service will need to be armed with section 482.

III. The Armor of Section 482

Concern has been expressed as to which of the "opponents" is benefited by section 482.[109] Is this the ultimate and invulnerable weapon of the Internal Revenue Service?[110] Or has the personal service corporation finally found a strong defense against the Service attacks? The answer, if there is one, lies in an understanding of the provision itself and with the courts' interpretation and application of the statute.

A. The Purpose and Effect of Section 482

Section 482 provides:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.[111]

The statute is designed to put the controlled taxpayer on equal *tax* footing with the uncontrolled taxpayer[112] and to prevent "artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises."[113] To determine if reallocation is necessary, the controlled taxpayer is judged by the standard of arm's length dealing or of two uncontrolled taxpayers dealing with one another.[114]

The section envisions the correction of *two* different problems.

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[109]*See* note 26 *supra* and accompanying text.

[110]The dissenting justice in Commissioner v. First Sec. Bank, 405 U.S. 394 (1972), suggested that section 482 was "a sharp two-edged *tool* fashioned and bestowed by the Congress upon the Internal Revenue Service . . . ." *Id.* at 426 (Blackmun, J., dissenting) (emphasis added).

[111]I.R.C. § 482.

[112]Treas. Reg. § 1.482-1(b)(1), 26 C.F.R. § 1.482-1(b)(1) (1981).

[113]B. Bittker & J. Eustice, *supra* note 28, ¶ 15.06, at 15-21.

[114]Treas. Reg. § 1.482-1(b)(1), 26 C.F.R. § 1.482-1(b)(1) (1981).

The first concerns the intentional violation of the tax laws and the resulting evasion of taxes.[115] The second, however, implies no improper motive or illegality, but merely recognizes that shifts may be necessary to clearly reflect income when the same interests control two enterprises.[116] In each instance, the Commissioner is authorized to adjust the income between the two controlled entities to correct either type of problem.

Section 482 allocations, however, are less onerous than allocations using the assignment of income doctrine, even when the same amount is involved, because of the effect of constructive dividends in the latter situation.[117] If an adjustment is made pursuant to section 482, the amount that has been added to the "employee's" income for tax purposes may be withdrawn from the corporation without tax consequence.[118] The assignment of income allocation, however, does not permit the same benefit. Any withdrawal of funds, including those on which the taxpayer has paid taxes due to the allocation, is considered a dividend.[119] The employee, therefore, is subject to a double tax if he attempts to obtain from the corporation funds which have been labelled "his income" by the Service.

Although section 482 provided some flexibility which the assignment of income doctrine did not offer, the section became operative only when three requirements were met: 1) two or more organizations, trades, or businesses; 2) common control; and 3) income distortion. These requirements were initially thought to prevent the application of the section to the personal service corporation.[120] This was not the case.

B. Section 482 and the Personal Service Corporation

The idea of using section 482 with the personal service corporation did not originate with the circuit court decisions of *Rubin* and *Foglesong*. By the time those cases decided that section 482 was the preferred method, its application in the context was an accepted proposition to the Tax Court. The early cases were fraught with problems, however, the most significant of which was how to meet the initial requirement of two controlled "*organizations, trades, or businesses.*"[121]

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[115]*See, e.g.*, Commissioner v. First Sec. Bank, 405 U.S. 394, 419 (1972) (Blackmun, J., dissenting).

[116]*See* B. BITTKER & J. EUSTICE, *supra* note 28, ¶ 15.06, at 15-21.

[117]*See* Battle, *supra* note 1, at 807-08.

[118]Treas. Reg. § 1.482-1(b), 26 C.F.R. § 1.482-1(b) (1981).

[119]*See* Battle, *supra* note 1, at 807-08.

[120]*See* Ach v. Commissioner, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 358 U.S. 899 (1966).

[121]*See* notes 121-36 *infra* and accompanying text.

Ach v. Commissioner,[122] the first case to apply section 482 to a personal service situation, represented a sympathetic case for the broadening of the statutory language; it, thus, formed the necessary foundation for later, more significant steps. In *Ach*, Pauline Ach was the owner and operator of a successful dress shop. Her son, Roger, operated a failing dairy corporation which was indebted in excess of $250,000 to Earnest Ach, Roger's father, who had covered yearly losses. In 1953, the corporation changed its name, expanded its stated purpose, and discontinued the dairy business. Although not a shareholder at the time, Pauline was voted president, treasurer, and board chairman of the new family corporation. She then sold to the corporation her dress business for its stated book value, an amount approximately equal to one year's net profit. Even though Pauline continued to operate the business as she had before, she received no salary from either enterprise. The corporate profits, earned from the dress shop, were used to pay the price of the dress business and to repay the indebtedness of the dairy business. No taxes were owed because of the carry-over losses from the dairy, and Pauline paid no income tax because she received no salary.

The Tax Court noted that Pauline, because of her ownership and operation of the business, had *been* "a taxpayer of the character referred to in section 482," prior to the sale.[123] The sale of the business, however, constituted only the transfer of the "naked assets" to the corporation which did *not* encompass the transfer of "Pauline's active participation as manager and guiding spirit."[124] The court thus concluded that "sufficient aspects of the business remained with Pauline so as not to deprive her of the status of a separate 'organization,' 'trade,' or 'business' within the meaning of section 482."[125] Once that hurdle was surmounted, the court had no difficulty finding common control and distortion of income.[126]

Using section 482, the court established that Pauline should be taxed on 70% of the profits from the dress business, the amount determined to be attributable to Pauline's services.[127]

Because the tax avoidance motives were so apparent and the end result was equitable, the *Ach* extension did not immediately cause the uproar that revolutionary change usually generates. The next case, *Borge v. Commissioner*,[128] likewise involved tax

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[122]42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966).

[123]42 T.C. at 124.

[124]*Id.*

[125]*Id.* at 125.

[126]*Id.* at 125-26.

[127]*Id.* at 127. The remaining 30% was attributable to the corporation which owned the assets and paid the employees.

[128]405 F.2d 673 (2d Cir. 1968).

avoidance.[129] Victor Borge, a famous entertainer, funneled his substantial entertainment income through his corporation which had also acquired his poultry business, a perpetually losing venture. Borge received a comparatively small salary pursuant to his five-year employment contract with his corporation. The corporation "did nothing to aid Borge in his entertainment business."[130]

The court found that Borge "owned or controlled two businesses, an entertainment business and a poultry business" for the purposes of section 482.[131] Borge relied on the Supreme Court case of *Whipple v. Commissioner*[132] which held that rendering services to a corporation as an investment was not sufficient to meet the requirements of a trade or business.[133] The court, however, was not persuaded by the investment argument but indicated that Borge entertained as a career and as his *primary* business.[134] After finding section 482 to apply, the court affirmed the Commissioner's allocation of $75,000 per year to Borge from his corporation.[135] This was still less than *half* of Borge's average annual net entertainment income.[136]

After the *Borge* decision, the clamor of concern and fear came.[137]

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[129]*Id.* Unlike in many of the other cases discussed, Borge was attempting to use the corporate structure to avoid application of another code provision, section 270.

[130]*Id.* The appellate court accepted the lower court's findings:

> that Borge operated an entertainment business and merely assigned to Danica a portion of his income from that business; *that Danica did nothing to earn or to assist in the earning of the entertainment income*; that Borge would not have contracted for $50,000 per year with an unrelated party to perform the services referred to in his contract with Danica.

Id. at 676 (emphasis added). Interestingly, the court in its presentation of facts noted that it was the corporation that contracted with third parties for Borge's services, although Borge's personal guarantee was also frequently required. *Id.* at 675. Given this corporate involvement, the conclusion that Danica did nothing to earn or to assist in the earning of income is difficult to justify without completely ignoring the realities of corporate existence.

[131]*Id.* at 675-76.

[132]373 U.S. 193 (1963).

[133]*Id.* at 202. The Court noted:

> Devoting one's time and energies to the affairs of a corporation is *not of itself*, and *without more*, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself.

Id. (emphasis added).

[134]405 F.2d at 676.

[135]*Id.* at 677. The Commissioner actually allocated $75,000 yearly for 1958-1961 and $25,000 for 1962, the only year Borge was paid the $50,000 stipulated salary. *Id.*

[136]*Id.* at 677.

[137]*See* Aland, *Section 482: 1971 Version*, 49 TAXES 815, 848 (1971); Fuller, *Section*

The implication of *Ach* and especially of *Borge* was that employment status alone was sufficient to create a trade or business.[138] The logical extension and the growing fear, therefore, was that section 482 could be used liberally to reallocate income whenever the Commissioner considered a corporate employee's salary inadequate.[139] It appeared that the Service had added its strongest weapon to the arsenal.

These fears did not subside with the addition of *Rubin v. Commissioner*.[140] On remand, after the Second Circuit found that section 482 was superior to the common law methods,[141] the Tax Court was not persuaded that the *Rubin* facts were significantly distinguishable from those in *Ach* and particularly from those in *Borge*.[142] The existence of a business prior to forming the corporation, as was the situation in both earlier cases, was not deemed to be of any more importance than merely a factor to be weighed in the trade or business determination.[143] Nor was the court moved by the variance in purpose between the corporations in *Ach* and *Borge* and the *Rubin* corporations; the lack of improper motives was insignificant.[144] The court further noted that in many ways *Rubin* presented a stronger case for section 482 application because of the absence of an employment contract with a covenant not to compete and because of the failure to relinquish any control of income production.[145] Although the court found that the existence of other shareholders who had made substantial capital contributions was a favorable factor, this did not influence the applicability of the statute. Instead it influenced the actual allocation.[146]

Perhaps most significantly, the court stated: "We rely on *Borge* for the proposition that assignment-of-income principles may be employed to the limited extent of supporting the existence of a trade or business on the part of a shareholder who purportedly acts as a corporate employee in conducting his business affairs."[147] With the control question directing assignment of income principles,[148] the

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482 Revisited, 31 TAX L. REV. 475, 477-81 (1976); Seieroe & Gerber, *Section 482—Still Growing at the Age of 50*, 46 TAXES 893, 895-97 (1968).

[138]*See, e.g.*, Seieroe & Gerber, *supra* note 137, at 895-97.

[139]*See, e.g.*, Rubin v. Commissioner, 56 T.C. 1155 (1971), *aff'd*, 460 F.2d 1216 (2d Cir. 1972).

[140]56 T.C. 1155 (1971).

[141]*See* notes 100-03 *supra* and accompanying text.

[142]56 T.C. at 1157-59.

[143]*Id.* at 1159.

[144]*Id.*

[145]*Id.* at 1160.

[146]*Id.*

[147]*Id.* at 1162.

[148]*See* note 96 *supra* and accompanying text.

conclusion is unavoidable that the controlling shareholder-employee will always be a trade or business[149] and the closely-held personal service corporation will always be subject to allocation by the Commissioner under section 482 *if there is a distortion of income.*

The *Rubin* court found a distortion of income and charged Richard Rubin's income with additional amounts.[150] Unfortunately, the court did not demonstrate how it arrived at the figures; however, the amounts were far less than the original stipulated allocation at the first *Rubin* trial.[151]

Thereafter, many of the courts fortunate enough to have a choice treated *Rubin* as an anomaly, ignoring it whenever possible, and continued instead to follow the time-honored, traditional common law doctrines.[152] Even the Service presented the common law arguments as its primary line of attack and kept section 482 as secondary reinforcement.[153]

The concept that *Rubin* represented a major deviation from mainstream judicial thought, however, lost some force when the Seventh Circuit agreed in *Foglesong v. Commissioner* with the Second Circuit's reasoning.[154] This fact in conjunction with the fact situation in which *Foglesong* arose did create immense concern about the future of the personal service corporation.[155]

Prior to incorporation, Foglesong was a sales representative for two separate steel tubing manufacturers. He was responsible for persuading potential customers to use the products of his "employ-

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[149]When confronted with the potential impact, the Tax Court indicated it was not holding that "employment status constitutes, in and of itself, a trade or business within the meaning of section 482." 56 T.C. at 1161. Instead, it asserted that the holding was "limited" to when the facts justify the conclusion "that a shareholder operated an independent business and merely assigned to the corporation a portion of the income therefrom, the business activity of the taxpayer may constitute a trade or business . . . ." *Id.*

On its second appeal to the circuit court, Richard Rubin argued that the Tax Court decision had creaded a "parade of horribles wherein the Commissioner would utilize § 482 to reallocate income so as to increase the salaries of all employees of controlled corporations whom he believes to have been intentionally underpaid." 460 F.2d 1216, 1218 (2d Cir. 1972). The court's response indicates its general lack of discomfort with the asserted proposition: "Although the prospect is not so shocking to us as to counsel, we find no need either to embrace or to reject the general proposition which the taxpayer limns." *Id.*

[150]56 T.C. at 1164.

[151]*Compare id. with* 51 T.C. 251, 264 (1968).

[152]*E.g.*, American Sav. Bank v. Commissioner, 56 T.C. 828, 839 n.10 (1971) (inapplicability of section 482 agreed by stipulation of the parties).

[153]*E.g.*, Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976).

[154]*See, e.g.*, Achiro v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,351, at 4089; Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,401, at 4183.

[155]*See* Burdett, *supra* note 26; Feuer, *supra* note 26; McFadden, *supra* note 9.

ers," to answer technical questions, and following a purchase, to continue to answer concerns and to service complaints. In August of 1966, he incorporated his business; he held 98 shares of common stock while his wife and his accountant had one share apiece. Also, his four young children became preferred shareholders; the subscription price of $400 was paid by Foglesong. Foglesong informed the manufacturers of the incorporation and of his desire for all future commissions to be paid to the corporation. The manufacturers agreed, although new contracts were not executed for several years. From September to December of 1966, Foglesong received no salary from the corporation, although the corporation received commissions for the period. During the next few years, he received a salary that was much less than the total commissions paid to the corporation as a result of his efforts. No employment contract with a covenant not to compete was executed between Foglesong and the corporation. The corporation, in addition, paid a dividend on its preferred stock only, totalling a sum of $38,000[156] for the years 1967-70.

The Tax Court relied primarily on Foglesong's total control and his obvious tax avoidance motives to find that 98% of the income was taxable to him personally.[157] The Seventh Circuit Court of Appeals found that the Tax Court, although "strongly influenced by the apparent flagrancy of the tax avoidance," had "substantially disregarded the Corporation for tax purposes"[158] under the guise of assignment of income principles; the court reversed and remanded for redetermination using section 482.[159]

Following the Seventh Circuit's decision, the legal forecasters predicted that, regardless of some favorable language in the opinion, the fate of the personal service corporation had been sealed.[160] The final battle had been fought, and although the corporations had struggled valiantly, refusing to surrender, the Service had won the war. Interestingly, the results predicted on remand turned out to be reality.[161] Two cases that were decided by the Tax Court during the interim period between the reversal and the remand, however, cast a different light on *Foglesong* and on the impact of section 482 in general.[162]

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[156]*See* 621 F.2d at 866 n.3.

[157]35 T.C.M. (CCH) at 1313-14.

[158]621 F.2d at 867.

[159]*Id.* at 873.

[160]*See, e.g.*, Burdett, *supra* note 26, at 334.

[161]*See* Burdett, *supra* note 26, at 334-35; McFadden, *supra* note 9, at 36.

[162]Achiro v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,351, at 4089; Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,401, at 4183.

IV. The Direction and Future after *Foglesong*

Because the closely-held personal service corporation has been held to meet the requirement of two commonly controlled "organizations, trades or businesses," then section 482 applies *if* there is a distortion of income.[163] The critical question, therefore, has shifted from a concern with trades and businesses to a consideration of income and distortion. To determine distortion, the courts have relied on the arm's length test.[164] Prior to applying this rule, however, the concept of income and its parameters must be defined.

A. Income

To determine whether income has been distorted, the employee-shareholder includes *both* his salary *and* the corporate contributions to his benefit plans.[165] One case, however, indicates that if the sole reason for establishing a personal service corporation is to gain the benefits of such plans and no other income distortion exists, the use of section 482 is not justified at all.[166]

1. Incorporation for Benefit Plans.—In *Achiro v. Commissioner*,[167] the Service argued that "incorporation for the principal purpose of taking advantage of corporate pension and profit-sharing plans amounts to an evasion or avoidance of income taxes, an unclear reflection of income, and/or an assignment of income."[168] The Tax Court held that although the petitioners incorporated primarily to obtain benefits, section 482 did not apply.[169]

In this case, both Achiro and Rossi, the petitioners, served as officers, managers, and 50% owners of Tahoe City Disposal, a corporation that operated a waste collection business. They also each acquired 25% ownership and management responsibility for Kings Beach Disposal Co., Inc. Both corporations employed additional personnel.[170] In late 1974, Achiro and Rossi, in conjunction with Achiro's wife and his brother, formed A & R Enterprises, Inc., with the brother owning 52% of the stock[171] and Achiro and Rossi owning the

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[163]*See* notes 147-49 *supra* and accompanying text.

[164]Treas. Reg. § 1.482-2(b)(1)-(3) 26 C.F.R. § 1.482-2(b)(1)-(3) (1981). *See also* notes 182-84 *infra* and accompanying text.

[165]Keller v. Commissioner, [1981 Transfer Binder] Tax Ct. Rep. (CCH) at 4183, 4190-91.

[166]Achiro v. Commissioner, [1981 Transfer Binder] Tax Ct. Rep. (CCH) at 4101.

[167][1981 Transfer Binder] Tax Ct. Rep. (CCH) at 4089.

[168]*Id.* at 4098.

[169]*Id.* at 4101.

[170]Tahoe City Disposal employed between nine and eleven additional people during 1975-77 while Kings Beach Disposal employed three to four people. *Id.* at 4091.

[171]Although the brother was the majority shareholder, he had very little contact

remainder equally. The corporate purpose was to provide management, consulting and advisory services. Twenty-year contracts for these services were made between this new corporation and the two waste collection corporations. Also, A & R executed employment contracts with Achiro and Rossi for five years of exclusive service. A salary and benefit plan provided the agreed compensation. Within a month, a profit-sharing plan and a pension plan were in effect for the two sole employees. The contributions to the A & R plans were substantially greater than that provided in comparable plans offered by the other two corporations.[172]

In response to the obvious scheme for higher qualified benefits, the Commissioner had allocated all service income from A & R to Tahoe City Disposal and Kings Beach Disposal using section 482.[173] After noting the purpose of section 482 and the prominent cases, the Tax Court found the section inapplicable.[174] The court, however, immediately hedged and noted that if the section was used in this situation, the allocations must be reasonable in light of the arm's length guidelines; the current transaction represented arm's length charges for the service rendered.[175]

There are a number of possible explanations and interpretations for the court's holding on section 482. The court may have been willing to find section 482 inapplicable because another code section corrected the real problem more directly. The major problem in this instance was not income distortion *between the three corporations*, but an obvious attempt to maximize the corporate tax benefits for Achiro and Rossi without complying with the nondiscrimination re-

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with or control of the management of the corporation, outside of offering some free advice on an infrequent basis. It was understood that he would *not* vote his stock or vote according to the direction of Silvano Achiro. *Id.* at 4091, 4094.

[172] *Id.* at 4904. The stipulation of facts provided a comparative chart:

	A & R		North Tahoe
	Profit Sharing	Pension	P-S Plan
Eligibility	No service requirement	No service requirement	One year of service
Vesting	100% upon participation	100% upon participation	10% after first year, 10% each additional year, until 100%
Contributions	Employers's discretion but not to exceed deductible amounts	10% of compensation	Employer's discretion but not to exceed duductible amounts

Id.

[173] *Id.*

[174] *Id.* at 4101.

[175] *Id.*

quirements for the waste collection corporations.[176] The court was able to rectify this difficulty using sections 401 and 414;[177] thus, contributions to the A & R plans were includible in the gross incomes of Achiro and Rossi.[178] The Service, additionally, was attempting to use section 482 to reallocate income among the three corporations, instead of between the personal service corporation and its employees. The court clearly saw no distortion of income among the corporations,[179] but it may have been more receptive to the section 482 appeal if the reallocation was between Achiro, Rossi, and A & R. Indeed, all the cases examined by the court were inadequate compensation cases.[180] The limiting language of the court may have been included to meet this contingency. The court also may have intended only to clarify that it might entertain section 482 arguments where incorporation is primarily to obtain benefits if other indicia of income distortion are present.

Although the true impact of *Achiro* is unclear, incorporation for the primary purpose of taking advantage of corporate benefit plans alone does not automatically "trigger" section 482. This construction is fortified by *Keller v. Commissioner*.[181]

2. Effect of Benefits on Income.—Keller v. Commissioner dealt with the more typical application of section 482 to a personal service corporation. Although the fact situation is complex and will be described in detail at a later point, for the purposes of this discussion, a summary presentation will suffice.

Keller, a pathologist, was a general partner with several pathologists. He received a share of the profits as income. When he became concerned about his family's financial future, he was advised

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[176]Certainly, one of the major purposes of the corporation was to permit adoption of benefit plans that would discriminate in favor of the petitioners and yet qualify under section 401 for exclusion from gross income. *Id.* at 4103, 4105.

[177]*Id.* The court required aggregation of employees between A & R and the Tahoe City Disposal pursuant to section 414. Notably, the distribution of the 52% ownership to the brother, the sole purpose of which was to avoid this result, was ineffective to prevent the aggregation. Because of the agreement not to vote or to vote in compliance with the wishes of Achiro, the voting rights of the brother were either disregarded or attributed to Achiro in determining whether a controlled group of corporations existed. *Id.*

[178]*Id.* at 4105.

[179]*Id.* at 4101.

[180]*Id.* at 4099-100. The court examined Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968), Jones v. Commissioner, 64 T.C. 1066 (1975), [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,401, at 4183, Rubin v. Commissioner, 51 T.C. 251 (1968), *rev'd and remanded*, 429 F.2d 650 (2d Cir. 1970), *on remand*, 56 T.C. 1155 (1971), *aff'd*, 460 F.2d 1216 (2d Cir. 1972), and Ach v. Commissioner, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1966).

[181][1981 Transfer Binder] TAX CT. REP. (CCH) at 4183.

to form a corporation to run his pathology practice. The corporation, which thereafter served in Keller's place as a general partner, adopted several benefit plans as well as executing an employment contract with Keller. The Service attempted to have all the income received by the corporation taxed to Keller individually based on the assignment of income doctrine or section 482.

The Tax Court found section 482 applicable.[182] It also recognized that the appropriate comparison figure for the arm's length determination was the "total compensation package,"[183] including corporate contributions to benefit plans.[184] Significantly, the court went on to note that the benefits were "probably worth more to petitioner than any equivalent payment he would have received outright."[185] The footnote indicated that the court was specifically referring to the tax reduction consequences of these plans.[186]

The importance of this assertion and this aspect of the case can only be appreciated if the arm's length test is understood. The concern under this test is whether income of the employee is "essentially equivalent" to his income absent incorporation.[187] Of course, the major problem, especially obvious in the one-person personal service corporation context, is that the corporation's sole employee received *all* the income before incorporation.

> [O]ne would expect petitioner, in an arm's-length transaction with an unrelated party, to have bargained for a total compensation package which would approximate the amounts he previously received as a sole proprietor. One would similarly expect that petitioner's total compensation would also reflect any increase in [the partnership's] earnings over and above the pre-incorporation years. To the extent of any meaningful disparity between these amounts, it is our view that the Commissioner is correspondingly justified in making an adjustment in petitioner's income to properly reflect the true taxable income he earned . . . .[188]

Under this test, any income less than the entire earning is subject to scrutiny.[189]

Keller received less income from the corporation than he had

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[182] *Id.* at 4189.
[183] *Id.* at 4191.
[184] *Id.* at 4191-92.
[185] *Id.* at 4192.
[186] *See id.* at 4197 n.15.
[187] *Id.* at 4191.
[188] *Id.*
[189] *Id.*

previously received as a sole practitioner *or* than he would have received absent incorporation. The Tax Court, nonetheless, found that his total compensation was "substantially proximate" to the figures he had received or would have received without the corporate structure.[190] The court relied on the "significant additional value to petitioner in any pension contributions as opposed to an outright salary"[191] to reach this conclusion. Recognizing that Keller's *taxable* income had been significantly reduced by incorporation, the court noted that the result was specifically provided by code sections which authorize income nonrecognition or deferral.[192] The use of the corporate form to manipulate income, thus, was not deemed to be problematic in this situation.

In making this decision, the court has changed the impact of section 482. The primary concern remains the distortion of income as determined by the arm's length transaction test and the employee-shareholder must still receive "essentially [the] equivalent" to the amount receivable absent incorporation, but the court has indicated that the *form* of that receipt is not necessarily a *limitation* if the form is one of which Congress approves for the corporate status. Furthermore, the form of the income may be a beneficial factor, as in *Keller*, if it provides "significant additional value."

This aspect of *Keller v. Commissioner* makes two important statements about the personal service corporation and section 482. First, to the extent that corporate benefit plans are authorized and encouraged by Congress, section 482 will not be used to interfere with the advantages afforded. Second and implied from the first, section 482 will allow recognition of the "corporateness" of the personal service corporation and will permit the benefits which accompany corporate status to inure.

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[190] *Id.* at 4192.

[191] *Id.* at 4193.

[192] *Id.* The *Achiro* court noted the same idea as it compared the benefits available to the self-employed person with those available through the corporate form.

> It is well-known that operating a business in corporate form provides advantages not available to self-employed individuals. In recent years, however, the driving force behind an ever increasing use (particularly by professionals) of corporations is the advantage of the richer tax deferral obtained through establishment of a corporate retirement plan. For example, for taxable years beginning before 1982, an employee not otherwise covered by a retirement plan is limited to the use of an Individual Retirement Account which permits qualified contributions not in excess of 15 percent of compensation or $1,500, whichever is less. Sec. 219. Also for taxable years beginning before 1982, the tax deferred contribution available to a self-employed individual under a Keogh Plan (also known as H.R. 10 plan) is limited to the lesser of $7,500 per year or 15 percent of earned income. Sec. 404(e)(1). For taxable years beginning after 1981, however, even active participants in

This conclusion is not negated by the *Foglesong v. Commissioner*[193] decision on remand. In this case, the Tax Court reached the same conclusion that had resulted the first time, although section 482 was used in lieu of the assignment of income doctrine.[194] Part of the 98% of the corporate income that was allotted to Foglesong represented a dividend distribution to the preferred shareholders.[195] Read broadly, this aspect of *Foglesong* would appear to deny the "corporateness" of the corporation by denying the propriety of corporate dividends by a personal service corporation and by taxing this distributed amount to Foglesong instead of to the corporation. Innocence, however, was not the hallmark of the dividend declaration and the court's reaction implied that the corporate form should not be used to achieve certain tax manipulations.[196] The funnelling of $38,000 to Foglesong's children as dividends on stock for which the subscription cost of $400 was paid by Foglesong himself represented one such transaction.

The *Foglesong* court, furthermore, explicitly noted its reaffirmation of the concepts that it laid down in *Achiro* and *Keller*.

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employer-sponsored plans may contribute to an Individual Retirement Account. Additionally, the maximum amount of a qualified contribution to an Individual Retirement Account is increased to the lesser of $2,000 or 100 percent of compensation. The Economic Recovery Act of 1981, Pub. L. No. 97-34, section 311, 95 Stat. 274-283 (1981). Similarly for taxable years beginning after 1981, the maximum contribution to a Keogh Plan is increased to the lesser of $15,000 or 15 percent of income, and the amount of income that can be taken into account when computing the deduction is increased from $100,000 to $200,000. The Economic Recovery Act of 1981, Pub. L. No. 97-34, section 312, 95 Stat. 283-285 (1981).

In contrast, under a qualified pension or profit-sharing plan a corporate employee-shareholder can enjoy annual contributions on his behalf to defined contribution plans in an amount not exceeding $41,500. Sec. 415(c)(1)(A); I.R.S. News Release 81-16, February 4, 1981. Alternatively, under a qualified defined benefit pension plan the maximum contribution is an amount that will provide him with an annuity of $124,500 or an annuity equal to his average compensation for his most remunerative three consecutive years. Sec. 415(b)(1); I.R.S. News Release 81-16, February 4, 1981. The corporate employee can also have a combination of benefits through contributions to both defined contribution plans and defined benefit plans subject to the rule of 1.4. Section 415(e).

[1981 Transfer Binder] TAX CT. REP. (CCH) at 4097 (footnotes omitted).

[193][1981 Transfer Binder] TAX CT. REP. (CCH) at 4245.

[194]*Id.* at 4247.

[195]*See* notes 156-57 *supra* and accompanying text.

[196][1981 Transfer Binder] TAX CT. REP. (CCH) at 4247. The court noted that, although the petitioner had some valid reasons for incorporating, the primary reason was to avoid taxes. Because of the inclusion of legitimate reasons, the corporation would not be ignored, but the Service was not obligated to approve *any* allocation of income that the two entities might decide feasible. *Id.*

> It is important to note at this juncture that it is not our intention to discourage the use of the corporate form for personal service businesses where one of the purposes of incorporation is to take advantage of certain intended Federal tax law benefits, i.e., medical reimbursement plans, death benefits, and retirement plans. . . . Clearly Congress has intended such a use of the corporate form, and it would be inappropriate for us to adopt a rule to the contrary.[197]

Section 482, therefore, has been used to recognize the personal service corporation as a viable corporate entity with the advantages and disadvantages that accompany the status.

B. Form and Formalities

Keller v. Commissioner also involved certain implications about the use of the closely-held personal service corporation within the framework and structure of other legally recognized entities and about the effectiveness of meticulous compliance with corporate formalities.[198] These implications inspired the wrath of the dissenters.[199] The *Keller* dissent seemed to forecast the death of the assignment of income doctrine in relation to the personal service corporations and to lament its replacement by such an ineffective tool as section 482.[200]

As previously noted, Keller, a pathologist, was a general partner of a partnership known as Medical Arts Laboratory (MAL). MAL provided only pathology services and received its laboratory and technical assistance from Medical Arts Laboratory, Inc. (MAL, Inc.), of which the MAL partners were directors and shareholders. MAL had no equipment, supplies, or medical personnel. MAL paid MAL, Inc. for the technical and laboratory services provided and the MAL partners provided supervisory assistance to MAL, Inc. for a salary. Thus, Keller received his share of partnership income and income from MAL, Inc. for his supervisory role.

In 1973, Keller formed Dan F. Keller, M.D., Inc. (Keller, Inc.), became the sole shareholder, and was elected president-treasurer with his wife serving as secretary. By written agreement with

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[197]*Id.* (citing Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4183 and Achiro v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4089).

[198]*See* notes 202-03, 219-22 *infra* and accompanying text.

[199][1981 Transfer Binder] TAX CT. REP. (CCH) at 4198 (Wilbur, J., dissenting).

[200]*Id.* at 4205 n.11. A footnote clearly expressed this concern: "And plainly we will sooner or later be confronted with arrangements between professionals and corporations for which sec. 482 will be inadequate, and the decision today to so lightly discard the assignment of income doctrine will come home to roost." *Id.*

MAL, Keller, and the new corporation, Keller, Inc., was substituted for Keller as general partner, although Keller promised to guarantee Keller, Inc.'s obligations to the partnership. A similar agreement with MAL, Inc. was not made until over a year later. Additionally, an employment contract was executed between Keller and Keller, Inc. Bank accounts were opened. The name was changed on the door of the MAL facility and on the letterhead. Accounting books were maintained. All necessary forms and applications were filed with the Internal Revenue Service and the State of Oklahoma.

1. Formalities.—The Tax Court was obviously impressed with the "[s]ubstantial care . . . taken to observe the requisite corporate formalities . . . including the execution of an employment agreement . . . ."[201] Finding no fault with the corporation formation, the court concluded that the personal service corporation was organized as a corporation under state law and met the requirement for recognition as a corporation under Revenue Ruling 70-101.[202]

As previously noted, the court found section 482 to be applicable. In reaching this conclusion, however, the court appeared to take the step predicted by commentators[203] and stated that employee status was sufficient to meet the dual business requirement of the Code section.[204]

Once the court found a valid corporation and no distortion of income under section 482,[205] any argument posed by the Service, such as assignment of income, lack of corporate property or other employees, was labelled as an attempt to nullify the corporate existence.[206] The court apparently saw adequate protections within the definition of corporation and the safeguards of section 482 to conclude that once these hurdles had been overcome, all further arguments concerning income distribution would negate a prior conclusion[207] or

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[201] *Id.* at 4188.

[202] *Id.*

[203] *See* notes 137-38 *supra* and accompanying text.

[204] [1981 Transfer Binder] TAX CT. REP. (CCH) at 4190. The court noted that the business of the medical practice was operated on two levels, the corporate level and the employee level. The court further stated that "the corporation employs petitioner to perform the requisite services. Petitioner, in turn, is in the *business* of providing services as an employee of his wholly owned corporation." *Id.* (emphasis added). To support this extension, the court cited Primuth v. Commissioner, 54 T.C. 374 (1970), as holding that an employee is in a trade or business for the purposes of section 162. *Id.*

This aspect of the case was reiterated in Foglesong v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4247, when the court stated: "Because the petitioner *as an employee and the corporation* are separate taxable entities and *separate trades or businesses*, we hold . . . the threshold requirement of section 482, . . . is met." *Id.* (footnote omitted) (emphasis added).

[205] *See* note 190 *supra* and accompanying text.

[206] [1981 Transfer Binder] TAX CT. REP. (CCH) at 4194.

[207] *Id.* For example, the court recognized that attempts to shift all the income from

were redundant.[208] Indeed, the court found that the result of applying the assignment of income doctrine would have been the same as using section 482.[209]

The majority, thus, has added strength to the corporate recognition of the personal service corporation and has reinforced the necessity of careful compliance with the formalities of state and federal law to achieve this desired result.

The dissent was dismayed. It found this situation very similar to *Roubik v. Commissioner*[210] where the court relied on the assignment of income doctrine to tax the employees.[211] The facts, nevertheless, have often been cited to exemplify a sham corporation.[212] Like *Roubik*, the dissent noted that Keller, Inc. owned no equipment, incurred no debts, paid no salaries except Keller's and maintained no medical records.[213] Virtually all control was in the partnership and all equipment and support resources were in MAL, Inc. To the dissent, therefore, the unavoidable conclusion was that "Keller, Inc. was 'nothing more than a few incorporating papers lying in a desk drawer of no significance except when a tax return is due.' "[214] Given the general lack of substance, the dissent argued that the scheme was merely an assignment of income from Keller to his corporation and that it would have used the doctrine to tax Keller on *all* corporate receipts.[215] The dissenting opinion was in complete disagreement with the majority opinion as to the impact of the assignment of income doctrine in this case.[216] It noted with apprehension that the

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the corporation to Keller under any theory would effectively nullify the prior conferral of corporate status. *Id.*

[208] *Id.* at 4195.

[209] *Id.*

[210] 53 T.C. 365 (1969).

[211] *See* note 54 *supra* and accompanying text.

[212] *See* notes 54-56 *supra* and accompanying text.

[213] [1981 Transfer Binder] TAX CT. REP. (CCH) at 4199.

[214] *Id.* at 4200 (quoting Foglesong v. Commissioner, 621 F.2d 865, 873 (7th Cir. 1980) (Wood, J., dissenting)).

[215] [1981 Transfer Binder] TAX CT. REP. (CCH) at 4203.

[216] *Id.* at 4205. In a rather pointed footnote, the dissent clearly asserted its view of the majority's conclusion.

> The majority tells us (surely with tongue in cheek) that "The net effect of applying the assignment of income principles, thus, is the same, in this case, as applying section 482: petitioner is not directly taxable on all the income received by Keller, Inc." Since, if the assignment of income doctrine applies, precisely the opposite is true—petitioner will be directly taxed on all the income—this statement is patently false. And obviously for many reasons the results are not the same, but dramatically different, and that is what this case is all about.

Id. at 4205 n.10.

majority was willing to recognize the apparent grant of immunity against this doctrine when section 482 was deemed applicable.[217]

The dissent provides some helpful insights to the probable impact of the *Keller* decision. The dissent reads the majority as striking the final death blow to the assignment of income doctrine.[218] The dissent, in addition, notes the shift in focus from substance to form to formalities.[219] Although compliance with formalities has always been significant to the courts,[220] and the failure to follow requisite formalities has often been used to justify the imposition of additional tax under one of the common law doctrines,[221] formality now seems to be the only concern which permits the court to maintain the corporate integrity of the personal service corporation.[222]

Meticulous compliance with the requirements in state corporate organizational statutes, therefore, is more important than ever for the personal service corporation as is the strictest respect for the entity once it is created. This undue concern for detail may be sufficient to earn the label of corporation, which will not provide exemption from section 482 but will safeguard the personal service corporation from the dangers of the common law doctrines.

2. The Use of the Personal Service Corporation within the Framework of Other Entities.—The *Keller* decision showed little concern for the complexity or uniqueness of the arrangements. No increase in suspicion or scrutiny was apparently required because of the use of the personal service corporation within the structure of other lawful entities. Keller, Inc. had complied with the requirements of state and federal laws; contracts with the other entities had been executed. The personal service corporation had been respected, but the structure within which the corporation operated had seemingly no significance.

The dissent was appalled at the total arrangement. Noting with distaste the artificial division of the pathology practice itself, the dissent found that "[t]he addition of petitioner's corporation is one slice too many, tissue paper thin, without functional reality or economic substance."[223] To fully demonstrate the problems posed by

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[217]*Id.* at 4203.

[218]*See* note 200 *supra.*

[219][1981 Transfer Binder] TAX CT. REP. (CCH) at 4200. Noting that, even if Keller had carefully followed formality, Keller, Inc. was no more than an "incorporated pocketbook," the dissenting opinion bemoaned that "attenuated subtleties triumph over economic substance and practical reality, and form and artifice reclaim center stage of our tax laws." *Id.*

[220]*See, e.g.,* note 145 *supra* and accompanying text.

[221]*See, e.g.,* notes 54-56, 97 *supra* and accompanying text.

[222][1981 Transfer Binder] TAX CT. REP. (CCH) at 4194-95.

[223]*Id.* at 4199.

allowing this type of "contrived" structure, the dissenting opinion took the arrangement to its logical extreme, asserting that all the partners of MAL and all the employees of MAL, Inc. could incorporate and adopt benefit plans to fit individual needs without concern for the needs of other employees.[224] As the scenario was unfolded, however, the obvious concern of the dissent became apparent: the potentiality for abuse of benefit plans and avoidance of the nondiscrimination provisions.[225]

The dissent further noted that this corporation was not the type of entity which the Service had intended to fall within the definition of corporation under Revenue Ruling 70-101.[226] Because of the structure within which the personal service corporation existed, the corporation had virtually no control over the activities of its principal employee because most of these decisions were made at the partnership level.[227] With no control and with no equipment, facilities or employees, the corporation simply served no legitimate function except to funnel funds of the "employee" to the corporation;[228] this conduit role certainly did not produce the needed legitimacy. The dissent, therefore, concluded that the assignment of income doctrine was the appropriate tool to remedy the problems created by this complex arrangement.[229]

Again, the dissent's fears highlight the true impact of the case. The assignment of income doctrine has *no* place in the personal service context as long as even minimum respect is given to the corporate entity.[230] Section 482 will always apply to these corporations and the

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[224]*Id.* at 4200-01. After asserting that each partner could incorporate, the dissent painted a verbal picture of the resulting confusion.

> We would have MAL, Inc., at the center surrounded by the partnership and eleven corporate arms extending out in different directions, each a hollow prosthetic device without offices, a laboratory, equipment, facilities, employees, medical records, or any other items normally used in the practice of pathology. The sole function of this paper octopus would be to serve as an incorporated pocketbook, enabling each physician to have a pension plan and fringe benefit package tailored to his own preferences without regard to the quite different preferences of each of his partners and whether or not the employees of the business were provided anything at all.

Id. (footnote omitted).

[225]*Id.* The dissent seemed concerned with the possibility of manipulations found in *Achiro*. *See* notes 171-72, 176-78 *supra* and accompanying text.

[226][1981 Transfer Binder] TAX CT. REP. (CCH) at 4201. The dissent argued that the ruling had intended to benefit the incorporation of a professional business, complete with assets, equipment, facilities, personnel and other attendants commonly associated with the practice of a profession. *Id.*

[227]*Id.* at 4199-201.

[228]*Id.* at 4201.

[229]*Id.* at 4201-03.

[230]*See* note 200 *supra*.

shareholder-employee(s).[231] While these ideas epitomize the *Rubin* and *Foglesong* reasoning, neither *Keller* nor *Achiro* are appealable to the Second or Seventh Circuit Court of Appeals.[232]

Benefit plans, additionally, are a valid corporate entitlement and may be the sole reason for incorporating. The majority suggested that the desire for qualified benefits, only available through the use of the corporate form, may constitute a business purpose under the *Moline Properties* test.[233] If not, the corporation must carry on a business.[234] As the dissent has indicated,[235] however, this must be a very low threshold requirement if Keller, Inc. met the criteria.[236]

The dissent also noted with displeasure that the sole corporate employee was able to have a tailored benefit plan without concern for the needs of the other employees in other levels of the structure. The majority, however, almost encouraged such use of the corporate form.[238] Apparently, the majority found the reasoning of *Achiro* to be persuasive, although this was not explicitly developed in the opinion. If the use of the corporate form to gain qualified benefits which, in effect, discriminate against employees in another part of the "structure" is the "evil" to be corrected, section 482, the assignment of income doctrine, and other judicially-created principles used to reallocate income are simply not the appropriate tools.[239] If there are loopholes in the code that allow these inequities to occur, then Congress needs to close them. Section 482, however, should not be stretched beyond recognition to remedy this situation.

If the personal service corporation is authorized under state law to serve as a partner or in any other capacity needed to create a superstructure,[240] then the complexity of the arrangement is not problematic when the corporate identity is respected. Seemingly, it is unnecessary for the corporation to establish all policy or to maintain strict control over the activities of its employee(s) if the corporation has sufficient input into the decisions of the controlling body.[241] In *Keller*, the corporation acted as a general partner and

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[231]*See* note 204 *supra* and accompanying text.

[232]*Achiro v. Commissioner* is appealable to the Ninth Circuit and *Keller v. Commissioner* is appealable to the Tenth Circuit.

[233][1981 Transfer Binder] TAX CT. REP. (CCH) at 4193-94.

[234]*Id. See also* note 51 *supra* and accompanying text.

[235][1981 Transfer Binder] TAX CT. REP. (CCH) at 4202-03.

[236]*Id.* at 4193-94.

[237]*See* note 224 *supra.*

[238]*See* [1981 Transfer Binder] TAX CT. REP. (CCH) at 4193-94.

[239]*See* notes 176-78 *supra* and accompanying text.

[240]The capacity question was not raised in *Keller*. [1981 Transfer Binder] TAX CT. REP. (CCH) at 4196 n.1a.

[241]The dissent pointed out the control of the partnership: "The partnership

exerted as much influence as any other partner.[242]

These cases indicate that the personal service corporation has, at long last, been given its fitting title of *corporation*. With the title comes all the advantages and disadvantages of the status. Abuses resulting from the special nature of this corporation are still subject to the sanction of reallocation under section 482.[243]

C. *Impact on Planning*

Keller, *Achiro*, and *Foglesong* have indicated a new understanding and appreciation for the personal service corporation through the vehicle of section 482. These cases also provide useful insights for the tax planner who wants to avoid the dangers common in this context. The following should serve as a checklist for preventing or at least reducing the likelihood of reallocation.

1. The Definition of Corporation.—The first major hurdle to avoid all Service arguments for reallocation is to meet the criteria for attaining the "corporate" label. This includes careful, complete compliance with state law, both as to organization and ongoing operation.[244] Although the state label does not necessarily require corporate recognition for federal tax purposes,[245] nonetheless the state status adds weight under Revenue Ruling 70-101 for the corporation being "organized and operated as a corporation" and facilitates the conclusion that it should "be classified as such."[246]

2. Employment Contracts.—One of the most frequently cited instances demonstrating lack of corporate respect and of corporate control is the failure to execute an employment contract with a covenant not to compete.[247] If the covenant is not included, the shareholder-employee must provide his services exclusively for the corporation to avoid an argument that the corporation had no control over the activities of its employee.[248]

Once the employment relationship is created with the accompa-

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establishes every essential element of the business—from fees charged and customers served to the division of the income among the eleven partners in accordance with the partnership agreement." *Id.* at 4199. However, it seemingly found no significance in the fact that the corporation, through its sole agent, exercised some control.

[242]*Id.* at 4185.

[243]*See, e.g.*, Foglesong v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,423, at 4245.

[244]*See* notes 201-02 *supra* and accompanying text.

[245]*See, e.g.*, Burnet v. Harmel, 287 U.S. 103, 110 (1932).

[246]Rev. Rul. 70-101, 1970-1 C.B. 278, 280.

[247]*See* Burdett, *supra* note 26, at 336.

[248]In *Keller*, the majority refused to grant unreasonable weight to the fact that the employment contract did not include a covenant not to compete. [1981 Transfer Binder] TAX CT. REP. (CCH) at 4194-95.

nying agency relationship, the Service's argument that the corporation failed to conduct business is difficult to maintain, even against the one-person personal service corporation. This was noted by the *Keller* court: "Certainly petitioner performed the only services for which Keller, Inc. was compensated, but it is axiomatic that a corporation can only perform services through its agents, whether it be a one-man corporation or an international conglomerate."[249]

Although execution of an employment contract may seem like a meaningless formality in light of the realities of the personal service corporation, the benefits of compliance certainly outweigh the minor inconvenience.

3. Contracts for Rendition of Services.—Related to the employment agreement requirement, and equally important, the corporation must be substituted for the "now-employee" on all service contracts that may have existed prior to incorporation.[250] While the court may find a novation if the parties have been informed,[251] the more likely response of the Tax Court is to have all income earned before the contract revision taxed to the employee.[252] Likewise, this result is not circumvented simply by having the *corporate name* substituted for the employee's on payment checks.[253] Immediately after formation of the corporation, therefore, the new corporation must make new agreements with the service recipients for the services of the shareholder-employee(s).

4. Salary and Benefits.—In calculating the value of the employee's total compensation package, the corporation must be guided by the arm's length test, the measuring stick of section 482.[254] The test itself, unfortunately, does not provide much concrete guidance, but because the court would consider the employee's compensation prior to incorporation and the compensation potential absent incorporation,[255] these represent important considerations for the corporation to use as well. The total compensation, however, does not need to be salary, but may also include benefit plans.[256] If

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[249]*Id.* at 4195.

[250]Keller did this with the partnership immediately, but failed to bring about the change with the corporation, MAL, Inc., for over a year. *Id.* at 4186.

[251]The Tax Court found a novation in *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309, 1315 (1976).

[252][1981 Transfer Binder] TAX CT. REP. (CCH) at 4183.

[253]This ploy proved ineffective in *Keller*. Although no formal agreement was made between MAL, Inc. and Keller, Inc., Keller convinced MAL, Inc. to substitute Keller, Inc. for Keller on the checks. *Id.* at 4186. The court was not deceived and the income earned from MAL, Inc. prior to a formal contract was taxable to Keller individually. *Id.* at 4192.

[254]*See* notes 187-89 *supra* and accompanying text.

[255][1981 Transfer Binder] TAX CT. REP. (CCH) at 4183.

[256]*See* notes 183-86, 190-92 *supra* and accompanying text.

the benefit plans are qualified, the corporation may acknowledge that this has reduced the employee's taxable income and, therefore, has provided "significant additional value" in this form as compared to salary form.[257]

Once compensation terms have been reached, payment should be made at regular intervals.[258] Having the corporation withhold payments for a few months may provide tax advantages to the employee, but it is also a sign of lack of corporate control and an indication of a non-arm's length transaction.[259] This manipulation results in reallocation of withheld income under section 482. The desired tax benefit, therefore, is not obtained.[260] Having displayed such a cavalier regard for the corporate entity, the employee also may be subject to greater suspicion by the court on other aspects of the income split.

The concerns of the court in cases like *Keller*, therefore, must be the concerns of the personal service corporation in fixing the salary and fringe benefits of its employees. Moreover, careful attention must be given so that regularity is the hallmark of employee salary payments.

These four areas represent the major obstacles faced by the personal service corporation under section 482. Care in these areas should also prevent the court from allowing the Service to seriously mount arguments under the assignment of income doctrine.[261] The use of the personal service corporation within the context of complex structure should not alter the section 482 analysis. The complexities, however, may create problems with the nondiscrimination requirements for qualified benefit plans.[262] Problems posed by these benefit plans, nevertheless, are not problems to be alleviated by section 482.[263]

A thorough understanding of section 482 and a sensitivity to its purpose and provisions during the planning stages of the personal service corporation should reduce conflicts and disagreements with the Commissioner and the Service at later points.

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[257]*See* note 186 *supra* and accompanying text.

[258]*See, e.g.*, Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,423, at 4245.

[259]Foglesong v. Commissioner, 35 T.C.M. (CCH) at 1313-14 (assignment of income doctrine used to tax earnings to "employee").

[260]Foglesong v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4246-48 (same result using section 482).

[261]*See* notes 209-12 *supra* and accompanying text.

[262]Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4197 n.4 (Wilbur, J., dissenting).

[263]*See* notes 176-78, 239 *supra* and accompanying text.

V. CONCLUSION

Because employee status is now sufficient to constitute a trade or business under section 482,[264] the dual business requirement poses no barrier to the application of section 482 to the personal service corporation. Although this dreaded expectation has become reality,[265] this does not require the acknowledgement of a sound defeat and the clamoring to surrender. In fact, the personal service corporation may claim minor victories and rejoice at the demise of the assignment of income doctrine in this battlefield and at the long awaited recognition of its existence as a viable entity.

Section 482 provides a mechanism to carefully balance the special nature of the personal service corporation and the policies underlying the graduated income tax.[266] Some income manipulations, like qualified benefit plans, have received the blessing of Congress. Section 482 recognizes that to deny these corporate advantages is to deny corporate status. These manipulations are permitted, and even encouraged. Other income manipulations, however, exist only because control of the personal service corporation is, by its very nature, held by the shareholder-employee. Section 482 notes that such unlimited control does not usually exist in the corporate structure; hence, to limit the control does not prove fatal to the corporate entity. Unbounded control in an employee is simply not a common corporate characteristic.

Full recognition of corporate status requires the personal service corporation to bear both the advantages and disadvantages that attach to the corporate label. Therefore, to put the personal service corporation and its employee, on an equal tax footing with the typical corporation and its employees, section 482 reallocates income based on the standard of arm's length transactions.

Unlike the common result using the assignment of income doctrine, reallocation under section 482 can be accomplished with less sweeping measures than total income allocation to the employee. Additionally, the advantages of fringe benefit plans are an appropriate consideration.

Section 482 accomplishes its intended purpose without providing actual advantages to either the Service or the personal service corporation. It provides the Service with a tool to reallocate income that has resulted from taking undue advantage of the unique nature of the entity. At the same time, it allows the corporation to be a

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[264]Foglesong v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4247; Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4189.

[265]*See* notes 139, 148-49 *supra* and accompanying text.

[266]*See* note 12 *supra*.

corporation with all the benefits and detriments of that status.

Perhaps this use of section 482 has only effectively changed the battlefield with little impact on ending the war. If nothing else, however, it has helped to even the odds.